RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $185 Annually
Registered with the Securities and Exchange Commission

**February 25, 1981** **LETTER 803**

Feb. 17, DJIA 931.57; PTI 1388; A-D Ratio –18.74
Feb. 20, DJIA 936.09; PTI 1386; A-D Ratio –19.12

**THE MARKET:** According to the economic textbooks, the stock market exists for the purpose of raising equity capital for American business. But if you ask many an investor, the stock market exists for the purpose of separating them from their money.

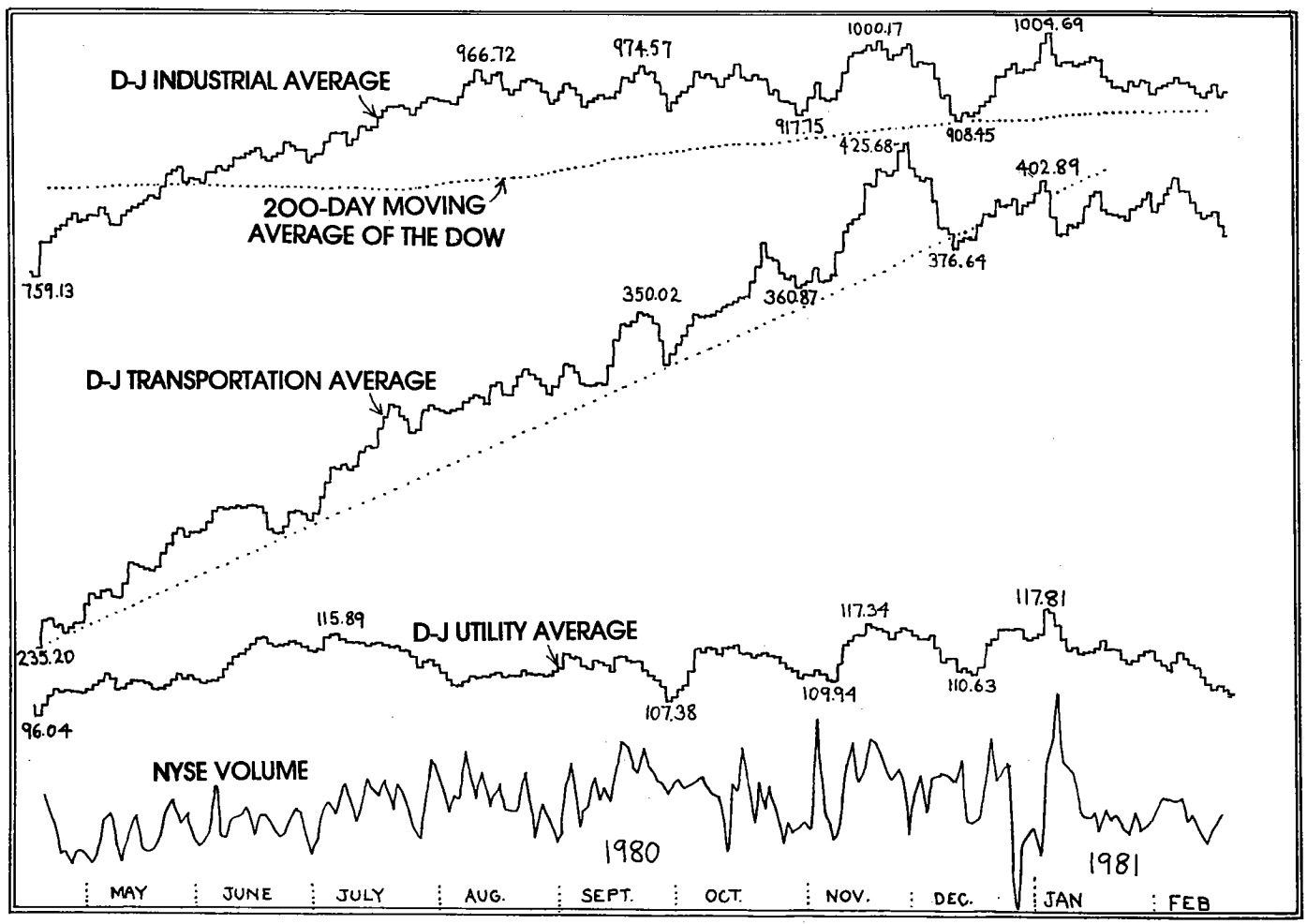
But "How?" you ask, "How can a market that is made by the minds and actions of men (and women) be so deceptive, so exasperating, and so costly? The answer is that the market possesses a life of its own. And it delights in generating two emotions in investors–fear and greed. On any sustained advance fear recedes and greed rises. On any sustained decline greed diminishes and fear surfaces. And then there is always the sideways or waffling movement. This is perhaps the greatest delight of the market, since extended sideways action (as now) produces a baffling mixture of hope, anguish, fear and ennui.

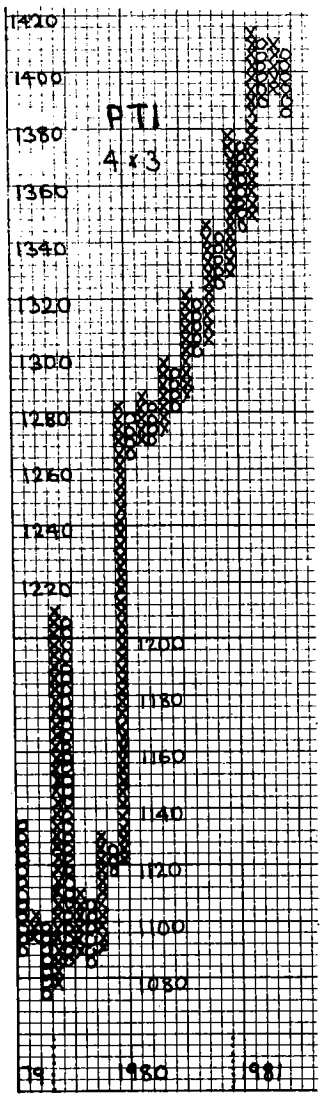
On the face of it, the stock market has looked precarious over the past few weeks. Study the chart of the Averages below. The D-J Transportation Average recorded a high of 425.68 on November 28. Following a sharp decline which took the two Averages to 908.45 and 376.64 respectively, the market turned up again. This time Industrials advanced to a new high of 1004.69. But the new Industrial high was NOT confirmed by the Transports. The two Averages then dribbled off in a series of half-hearted rallies and declines.

**FRONT PAGE COMMENT:** Well, the speech is out. My reaction–well meaning, far too many political compromises, financially a dream. The Reagan projection is for $125 billion in Federal deficits over the next three years. Ridiculous, in 1981 so far the Government has run a $62 billion deficit. It looks to me as though the whole projected $125 billion deficit could come through THIS YEAR!

Reagan is protecting $216 billion in social programs. On top of that, he has a $195 billion defense program. That's all you have to know. My best bet–the final cuts (when they get through Congress) will be around $10 to $15 billion. AND THAT ISN'T GOING TO BEGIN TO DO IT. As long as US Presidents continue to project any deficits at all, this nation is headed for trouble.

During the same period the D-J Utility Average (often a bellwether for the rest of the market) drifted below two preceding lows, the 110.63 low of December 16 and the 109.94 low of November 7. Only the September 29 low of 107.38 remains, and I would take a breaking of this low as a bearish omen.






There is a stock market territory that I call "no man's land."It is the most confusing area with which the market analyst has to contend. I define no man's land as the area in which the D-J Industrial and Transportation Averages are fluctuating below their last peaks but above their last lows. This is the territory that the Averages are in now.

A bullish resolution of the current no man's land puzzle would require Industrials to better 1004.69 confirmed with a Transport push above 425.68. A bearish resolution of the puzzle would entail Industrials breaking 908.45 confirmed with a Transport violation of 376.64. It is important to remember that the Dow Theory conclusions are only valid when BOTH averages penetrate significant preceding points (a penetration of one Average alone is more often than not deceptive).

I might add that in my experience stress always increases when the Averages are in no man's land. It is here that the investor's imagination seems to run wild, fed by strident predictions from leading market soothsayers to the effect that "the next major move will be to Dow 1200" or "the bottom will fall out of this market within two weeks." Veteran practitioners have learned, usually the hard way, to let the market do its own talking. That procedure is easier on the nerves–and far easier on the pocketbook.

In recent Letters I have stressed one principle: a market trend, once in force, is taken to continue until PROVEN OTHERWISE. The last market trend was bullish. And despite a veritable chorus from the bears of Wall Street (and despite my own misgivings regarding this market) I have not yet received proof that this market has turned bearish.

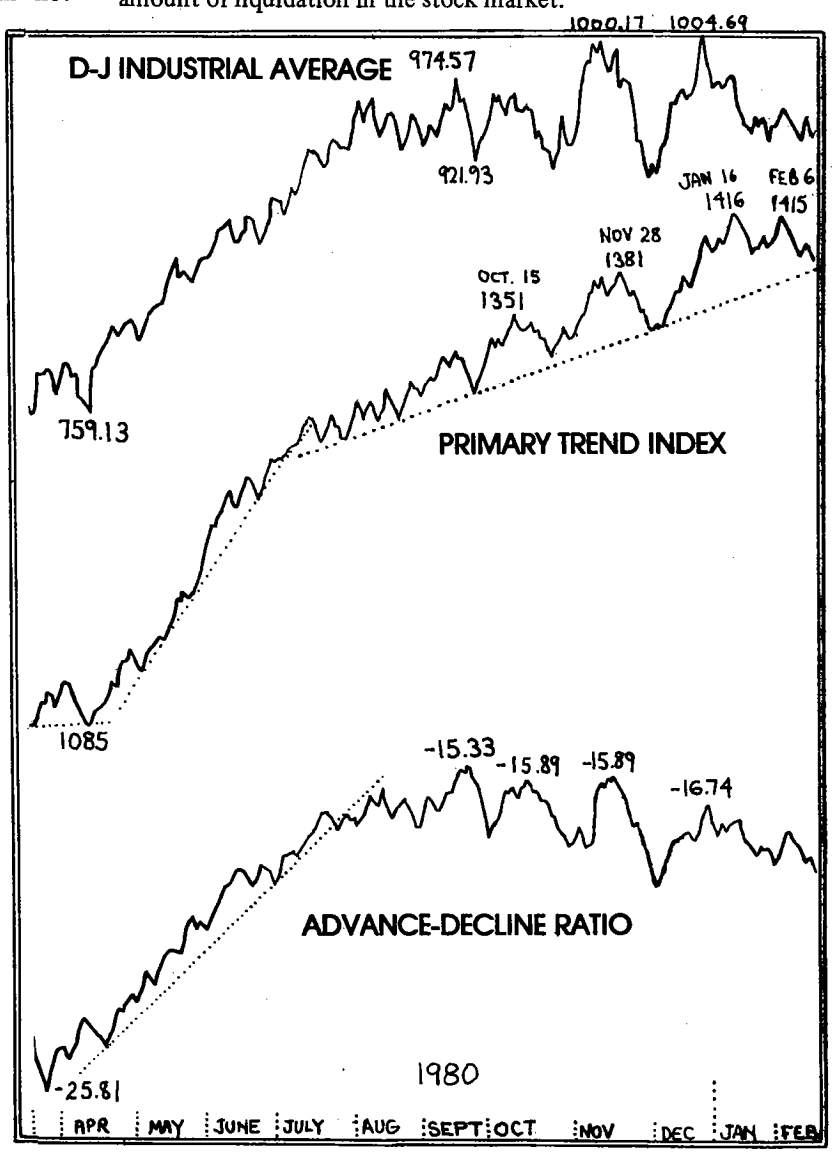
What would constitute bearish proof? (1) A primary bear signal in the Averages; such a signal would require Industrials to violate 908.45 confirmed by a Transport breaking of 376.64. (2) A breakdown of my Primary Trend Index (PTI), and by that I mean a decline below the long rising trendline as shown on the chart at right.

Turning to the PTI, I am at this time including a new study of this indicator. It's a point and figure chart (above) (each box equals 4 points) of the PTI covering the period of 1979 to date. Note that the current upturn and advance in the PTI began in March, 1980. On the chart we see that a base was built in the 1076 to 1112 area (during early 1980). When the PTI moved out of this base to the upside, we saw a straight-line advance to 1284. Then came a series of irregular rallies–to the January 16 record high of 1416.

Next the PTI formed a consolidation pattern. But on February 3, 1981 the pattern turned bearish when (for the first time during the entire advance from the 1980 lows) a preceding low in the PTI was violated. This occurred on February 13 when the PTI dropped to 1388. Thus, on the point & figure chart, we have the first bearish reversal in the remarkably persistent PTI uptrend.

Turning to my regular daily chart of the PTI and the A-D ratio, note that we have a PTI peak of 1416 on January 16 and 19. A decline to 1389 (on Jan. 26) followed, then a new rise to 1415 on February 6. The February peak failed by a single point to equal the January 19 peak. The PTI then sank back to within 10 points of its rising trendline. On February 13 (two days before the Reagan speech) the PTI dropped to a low of 1388. A short rally followed–and then more faltering. Final PTI comments will appear at the end of this Letter.

Note at the bottom of the same chart that the advance-decline ratio recorded its peak of minus 15.33 on September 19. On December 11 the A-D recorded a low of minus 19.52. A rally followed, but now in February we find the A-D just a fraction above that December low. My instinct tells me that any breaking of the December low in the A-D ratio would unleash a goodly amount of liquidation in the stock market.



Conclusion: Most of the indicators that I watch are moving down close to critical levels. At this point it simply doesn't pay to try to outguess the indicators (but it also does not pay to get caught if they do turn bearish). Watch 908.45 on the D-J Industrials and 376.64 on the Transports. A breaking of BOTH of those levels would signal a primary bear market. If that occurs, all subscribers should be out of stocks and on the sidelines. In the meantime both the PTI and the A-D ratio are close to "sell signal" levels. With so many of my indicators all so close to trouble areas, I would imagine that if the market is fated to "go," all the indicators will plunge together.

**INVESTMENT POSITION:** I continue of the opinion that the best risk/reward situation today is in 91-day Treasury bills. The point & figure chart of the PTI bothers me, and it makes me even less eager to hold stocks at this time. True, the PTI has not yet broken its rising trendline, but I'll personally stay with the T-bill position.

I said in the last Letter that gold positions (even trading positions) are OK on the stipulation that you sell if gold breaks spot 482.

**JAWS, 1981: Question:** Russell, I note that despite your PTI and despite other considerations, you have been all along recommending large holdings of cash, and more specifically Treasury bills. Why are you so fond of the T-bills?

**Answer:** First, they are about the safest liquid investment, having behind them the full faith and credit (and taxing power) of the US Government. Second, the T-bills provide a very high rate of return, right now above 15%. In case you didn't know it, at 15% compound interest money doubles in less than 5 years. Third, T-bills are extremely liquid; they can be bought and sold in almost any quantity at a moment's notice. Fourth, debt and rising interest rates in the US are literally destroying the nation's long-term credit markets. As this process continues, the money markets will come under increasing pressure. The greatest pressure will be concentrated in the short-term money markets, and the prime beneficiaries on that squeeze will be those who hold (safe) short-term paper. The short-term paper that is most attractive is the T-bill.

**Question:** I don't quite understand what you mean by the destruction of the nation's long-term credit markets. Please explain.

**Answer:** All right, in order to understand this concept (to me, it's more than a concept, it's a certainty), you have to understand compound interest. This is the thing no one seems to comprehend. This is the thing no one wants to talk about. Reagan does not mention it, Stockman doesn't talk about it, Regan says nothing about it. Congress doesn't know it exists, but it's the spector that's enveloping America.

Let me explain. Let's take the Government alone. The US Federal debt is now $940 billion. The average maturity of this debt is 3 years, 9 months. The average interest on this debt is 10.1%. Shortly, the whole $940 billion debt will be rolling over (plus new deficits) at 10%, then 11%, then higher. The interest on the Federal debt in 1981 will be approximately $94 billion (see chart). At 10.1%, money doubles in less than 8 years. So assuming that there are no new budget deficits (and that's a ridiculous assumption), the interest on the debt will rise to $197 billion (almost $4 billion a week) by 1989. If the deficits continue to build, that figure will arrive much earlier.

Right there you are talking about a formula for national bankruptcy. How the devil is the US Government going to raise that kind of money in these battered money markets year after year? The answer is that they are not–they can't! So as I review the Reagan statements, as I mull over the Stockman statements, I realize that these well-meaning men are far too complacent, far too optimistic. If I were President I would now OPT FOR BUDGET SURPLUSES! I would put it on the basis of either paring down the national debt, cutting out inflation entirely, bringing spending down below income, or facing national catastrophe. Let me put it this way: if our leaders don't understand what's happening, if they don't see that rising debt at compound interest rates is destroying the American economy, then the markets will be doing the "seeing" for them. And that's going to take the form of an across-the-board collapse of the financial markets!

**Question:** Wait a moment, Russell, when you talk about running surpluses and cutting Federal spending in a massive way, you are talking depression. Are you aware of that?

**Answer:** Of course I'm aware of that. Look, there is no choice. You can go bankrupt via the Chinese water torture method of continued inflation and an ultimate wipe-out of all purchasing power (together with democracy and freedom), or you can take the depression, but save the free-enterprise system and move towards putting the whole machine back in working order. The fact is that a recent poll showed that the American people place balancing the budget at the top of the list of things the Government should do. People know what's wrong. They know that the Government is ultimately subject to the same laws they are subject to, but the people have to be led, they have to have hope, and that's exactly why Reagan was elected. But as I see it, Reagan is still not stating the case strongly enough. Reagan's cure will not work, it won't work because he's not willing to go far enough.

**Question:** How far does he have to go?

**Answer:** If this economy is to be saved, we have to produce actual surpluses, we have to spend LESS than we take in, the Government has to ERASE debt in a steady, consistent program. A business on the edge of bankruptcy has to systematically pare down its debt. The US Government MUST do the same thing. And unfortunately, that means that there can be NO SACRED PROGRAMS in this nation. Social Security, Medicare, Health programs, Welfare, they must all be curtailed or turned over to the private sector. These programs are where the BIG SPENDING IS! Social Security alone will bust this country if it isn't cut sharply.

**Question:** Well, Russell, I don't see Reagan or anyone else talking or acting that tough. In fact, Reagan has listed the programs that he won't touch. So let's go on from there. Let's assume that Reagan and Stockman don't cut as much as you want them to cut, and that some of your dire predictions start materializing. Let's assume that within a year or so (maybe less) the interest on the national debt starts crushing the financial markets. What happens next?

**Answer:** In answer to that, many people will tell you that the Fed will just continue to monetize the deficits, and at that point the nation will move into a hyper-inflationary situation. I don't agree.

As I see it, the hyper-inflation thesis is not going to work. It won't work because the debt will kill it. Even now you're seeing

some of the deflationary effects of debt. The bond markets have collapsed, commodities have been hit hard, collectibles are soft, housing is weak. But yes, you're right, many prices are up and still going up. And what's happening is that businessmen are trying to retain profit levels by raising prices. Perhaps the greatest irony along these lines is the auto industry, which is having a disastrous time of it, but despite that, prices of autos are being raised.

That can only occur in the very **early** stages of deflation. In the next phase (and Chrysler has done this) the manufacturer goes to the union and says, "Look boys, either you take a cut in wages or we close down the factory. We're going broke, and if you take your usual stand, you'll have a raise and no job. So take your choise." And then the union takes the cut, and next the manufacturer starts dumping his goods, and before you know it you're into deflation. But that's a ways off. As long as businessmen and citizens can borrow, as long as Government handouts continue, the illusion of prosperity can continue. But the party is nearing its end. And the obituary will be written in the money markets.

**Question**: You seem to blame everything on the Government, Russell. But what about private industry?

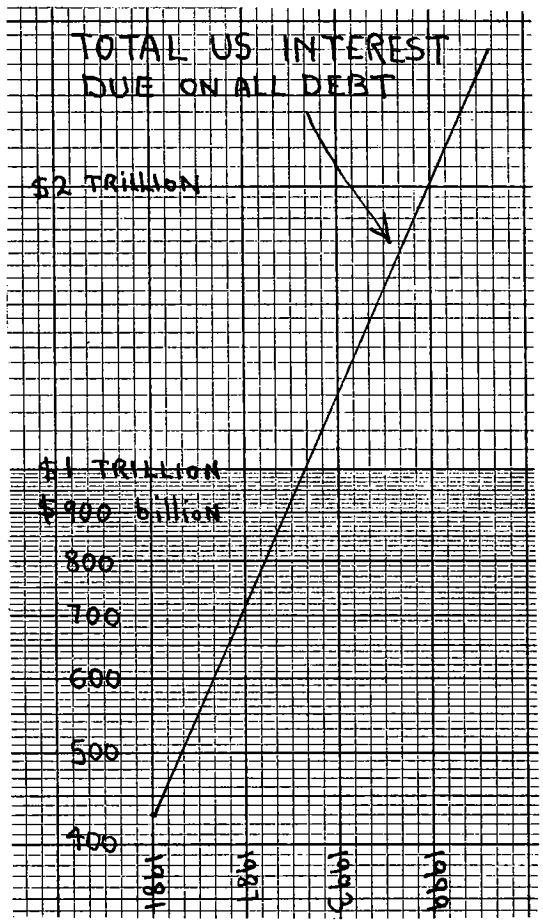
**Answer**: If I blame everything on the Government, I'm sorry. But it was the Government that really encouraged borrowing and debt. The Government itself sets the example. And the people say, "Hey, if Uncle Same can borrow and go over his head in debt, why can't I? Furthermore, look how easy the banks and the Fed and the Government are making it for me to borrow!"

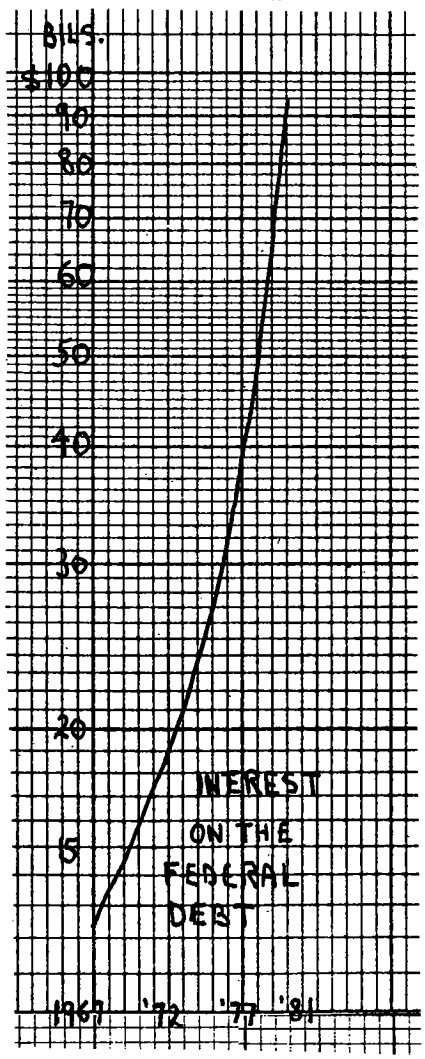
Look, I want to give you some statistics that will knock your eye out. The *total debt* of the nation is now about $4.3 billion. Break it down this way. Let's assume that all this debt comes in at around 10% interest (actually it is higher). You have consumer debt of $1.3 trillion, so the interest on the consumer debt is $130 billion a year. The states, municipalities and cities have $1 trillion in debt so they pay $100 billion a year in interest. The Government has $1 trillion in debt, and this is another $100 billion in interest annually. Finally, corporate debt is $1 trillion and this is another $100 billion in interest. So you are talking $430 billion in interest on all debt (but this interest is rising and so is the debt!).

The accompanying chart shows what happens to that $430 billion in interest over various time spans (and this is assuming just 10% in interest and no further increase in the actual debt!). What happens is that ***the interest payments explode!*** By 1986 the interest payments balloon to $761 billion. By 1993 the payments rocket to $1.34 trillion! In other words, through time the payments on this debt blast off into outer space (which is a nice way of saying "bankruptcy").

**Question**: So what's the answer, Russell?

**Answer**: What you're seeing now is what I call the first stage of the debt and spending crisis. This is the very early recognition that there is a crisis. The proposed budget cuts of 1981, are, to my mind, a joke. They're far too small, but they are a start. Within six months we're going to see how minimal these little cuts really are. And I'm talking as if Reagan was going to get all his cuts through Congress (which he most certainly won't).



The second stage of the crisis is going to be the shock stage. That's when the nation realizes that the deficits are worse than ever, that nothing has been solved. The final stage will be the one in which the markets are collapsing and in this stage the people and the politicians will realize that there's no painless, easy way out. In this final stage we will see massive cuts in Government: whole departments will be shut down, thousands of Federal employees will be fired, payrolls will run out. Reality will hit the nation full in the face.

**Question**: What kind of reality are you talking about?

**Answer**: Two kinds of reality. One is a collapse in the money markets and an almost total inability to sell any debt of over two years maturity. Second, Federal deficits running on an annualized base of maybe $200 billion a year or more. Under those conditions, the politicians will finally be backed against the wall. And remember, the only time politicians ever move is when their backs are flush against the wall. Today, the politicians are backing up a bit, but they're still far from the wall. It's going to take another year or so before the bomb of careening deficits bursts over the nation. At that time it will be seen that the Reagan-Stockman proposals of 1981 were only a well-meaning token, a start!

**Question**: But what about this year's deficits and next? The Government is going to have to do something. It can't all be sold in the bond market. Won't the Fed try to monetize the deficits?

**Answer**: Sure, they'll try. But the situation will be out of hand. When the financial world sees the *size* of the looming deficits, they'll realize that any attempt by the Fed to monetize $150 to $200 billion in US deficits will literally wreck the dollar. At that point panic will overtake the markets, gold will probably rocket up into its third and final phase, and we'll enter a period of soul searching that will make today's financial debates look like tea parties. I tell you, this nation has not yet come to grips with what it is doing, what it is spending, what it is giving away, and where it is headed. We're still in dreamland–no, I'll modify that–we're in semi-dreamland.

**Question**: Russell,what would you do now if you were Reagan?

**Answer**: You really want to know? I'd announce that I'm running for *one term only*. I'd announce that I'm no longer a politician, because I have no further political ambitions. Then I'd get on TV and I'd tell the American people the real story of the debt, the interest on the debt, and the crisis that is looming. Next, I'd tell the American people that we're going into the damnedest crash program of putting this nation on a sound financial basis that anybody can imagine. My target would be to balance the budget in fiscal 1982. I'd tell the people that if Congress didn't go along with me I would resign (this is the way deGaulle did it). I'd announce that as President I was not going to do the whole thing myself, that Congress and the people were going to do it with me, or they'd have to get another President who would be willing to pussyfoot the US into dreamland. That's what I'd do–exactly that.

**Question**: Russell, you're a nut!

**Answer**: The country has literally gone crazy. If you were an accountant and you looked over this Government's financing, you'd say they were insame. So maybe it takes a nut or a madman to turn this whole mess around. I don't think "reasonable" men are going to be able to do it. There is nothing reasonable about the finances of the US Government, there is nothing reasonable about what's left of the US bond market, there's nothing reasonable about US deficits in almost every year since World War II.

**NOTES & QUOTES**: The US Post Office lost over $300 million last year. There's only one thing the PO excels in, and that's raising the price of US postage stamps. As a long time collector of US stamps, I've watched the face value of a first class stamp rise from 3cents to the current 15-cents. Now the PO is talking 18 or 20-cents.

Meanwhile, another company providing service to the public, AT&T, produced the biggest profit in corporate history, $6 billion last year. If I were President (and I'm serious) I would turn the whole PO over to private industry, issue stock, sell it to the public and await results (I'd probably have some AT&T boys in there as top executives). I'd bet that within 5 years the PO would be producing big profits.

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The price of top-grade diamonds has dropped about 17% this year (see last Letter comments). For this reason, giant deBeers has cut shipments of diamonds to the NYC centers by 60%. You've all heard the ads talking about "the one investment that has never gone down." Cancel that ad.

* *

In the "good old days" around 1961 when I first arrived in San Diego, I used to wax poetic about the wonders of this land and its climate. And believe it or not, dozens of my subscribers moved out here–and they thanked me for it. But now you can stay home. In the early 1960's San Diego was a sleepy town of 500,000 with big wide highways and few cars. By 1970 San Diego had become the 14th largest city in the nation, but the population was swelling (people were beginning to discover what I had discovered–there is a paradise in the US). Now in 1981 almost everyone knows about SD, and it is the 7th largest city in the nation with a population (up 24.7% since 1970) of 890,000. So now if you're looking for paradise, try Flagstaff, Arizona or Lake Tahoe. San Diego has dropped to "semi-paradise" and I'm not going to write about it too much any more (although it still has the best climate in the Western world).

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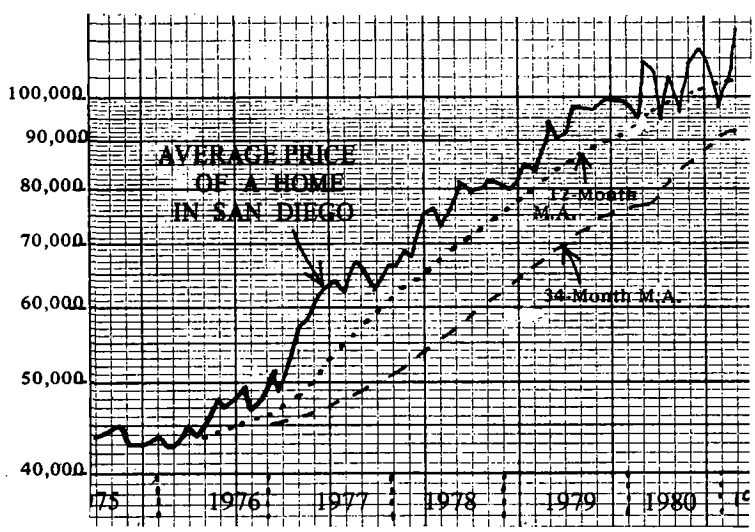
Mortgage rates are rough, but nothing, it seems, stops the upward price of housing in San Diego. Here is a seven year chart of "average home prices" in San Diego, with January producing a record high of $119,008 for a home. Pictured on the chart is the 12-month moving average and the 34 month MA (chart courtesy of my good friend, Jon Strebler of Drexel Burnham, La Jolla).



**GOLD:** The plunge in Swiss francs, German marks and gold have all gone to extremes. An upward correction (if nothing else) is in order. Fundamentally, I have to think that the hard money boys are less than impressed both with the Reagan proposals (they did not go far enough) and with the chance that even what Reagan did propose will not go through Congress.

In the last Letter I stated that gold buying was in order with the caveat that positions were to be cleaned out IF gold broke below the low of 482. To my mind, the 482 low of February 3 looks better and better. (i.e., less likely to be violated any time soon). Trading against the trend is always difficult and nerve-wracking, and the trend in gold is still technically down, although it could well be in the process of turning up.

One thing I am watching here is gold momentum. If gold can hold in the 510 to 530 area for the next month or so, gold momentum will turn up, and this would be a big plus in the gold equation.

A second area to watch is the ratio of gold to the Dow. This ratio turned down in mid-September and has been declining ever since. But a ratio figure of 575 will reverse the five month decline in the Dow/gold ratio. You can watch this ratio yourself. Each day simply divide the price of gold (spot) by the price of the Dow. For instance, today gold is 514.50 and the Dow is 933, providing a ratio of 551. At a ratio of 575 the relative strength line will reverse in favor of gold over the Dow. If this occurs, gold will receive a definite technical boost and in that case holdings of gold would be increasingly attractive.

In recent Letters I showed (see chart) the three downward thrusts in gold from the September high and I stated that the bearish potential is often exhausted with three downward thrusts. Note, also, that the third downward thrust ended just about on the lower channel line.

The bullish target for gold is a move above 520. The larger target is a full correction of the decline from 720 to 484. A minimum one-third correction of this 238 point decline would take gold back to 563, a 50% correction would take gold to 600.

**MONEY RATES:** With billions of dollars in new financing to pull off, the US needs all the help it can get. Therefore, the Fed is jumping at the chance to bring down Fed funds–and consequently, an explosive rally in the money market. But in my opinion what we're seeing is a bear market rally, with higher interest rates yet to come. However, bonds have come down very hard this year, and bear market bounces are usually more violent than the decline that preceded them. So here comes the bounce, and watch for the corporations to line up and sell their new bond issues–it's going to be a long, long line.

**LATE NOTES:** As of today (Monday, Feb. 23) it has been 23 trading days since the last high (Jan. 19) on the PTI. This is the **longest span** without a new PTI high since the whole rise began in March, 1980. Many have blamed high interest rates for the stock market weakness. But on Friday (Feb. 20) interest rates dropped sharply, the Dow was up almost 3 points, and the PTI dropped 6 points–to put it within only 5 points of that rising trendline. Therefore, any persistent market weakness this week will almost surely take the PTI below its trendline and render it bearish for the first time in 11 months.

The hardest thing to do when dealing with markets is to stay objective. To argue with the market is to court disaster. I have tried to stay objective about this market, and for months I have emphasized that the trend was bullish. If the PTI breaks this week I would say that the bearish evidence is in. A primary bear signal in the Averages (Industrials below 908.45, Transports below 376.64) would then seal the case for the bears.

The Utility Average (page 1 chart) has often led the way for the rest of the market. On February 20 the Utility Average closed at 107.27, thereby breaking below its September low and taking this bellwether Average to its lowest closing in 10 months.

**NEXT MAILING: March 11th**